

The President's Report to the Congress

on the

Compacts of Free Association

with the

**Federated States of Micronesia and the Republic
of the Marshall Islands**

2004

Introduction

The United States entered into a Compact of Free Association with the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) in 1986. The purpose of the Compact was to establish close and mutually beneficial relationships between the United States and the FSM and RMI as they emerged from the Trust Territory of the Pacific Islands and became sovereign states.

The Compact was made a part of and approved in Public Law 99-239. The Compact set out mutual obligations with regard to governmental, economic, security and defense relationships. One part of the Compact dealt with economic support provided the FSM and RMI by the United States. Between FYs 1986 and 2003, the last year of funding under the Compact's original terms, the FSM and RMI received approximately \$1.5 billion and \$1 billion, respectively, from the United States. The funding was used for general government operations, including health and education, economic development, capital improvements, and special purposes.

Some of the provisions of the original, 1986, Compact, including the economic assistance provisions, were to expire in 15 years. The Compact provided that, starting in 1999, the parties were to enter into negotiations regarding these expiring provisions. These negotiations culminated in separate amended Compacts with the FSM and RMI, which were made a part of and approved in Public Law 108-188, the Compact of Free Association Amendments Act of 2003. The amended Compacts provide United States support for a 20-year period that began in Fiscal Year 2004. The FSM will receive approximately \$2.1 billion and the RMI \$1.5 billion during that period, including large annual and increasing contributions to trust funds designed to provide an annual source of revenue when the annual United States assistance terminates at the end of FY 2023. Through FY 2023, United States assistance will be for grants in the sectors of education, health care, private sector development, the environment, public sector capacity building, and public infrastructure, with priorities in the education and health care sectors.

The amended Compacts created new accountability requirements for the use and reporting of United States' assistance. One of the requirements of Public Law 108-188 is this report.

(A) General Social, Political, and Economic Conditions:

Section 104(h) of Public Law 108-188 requires a Report by the President of the United States on the RMI and the FSM to discuss general social, political, and economic conditions, including, among other things, estimates of economic growth, per capita income, and migration rates.

Federated States of Micronesia (FSM)

I. Background

The government of the FSM has not yet developed indigenous capacity to generate and disseminate macroeconomic information and advice. Even basic statistics on the various components of the economy, the tax base, labor force, employment, wages and salaries, pensions and other commonly followed factors are not routinely compiled unless such activities are undertaken by outside entities.

A succession of foreign advisory teams, including the Economic Management Policy Advisory Team (EMPAT), funded in part by the United States since its beginning in the mid-1990s, has been employed over the last decade to generate and disseminate macroeconomic data and offer economic and financial advice to the national and state governments. Despite excellent work by outside entities, the skills to continue this work have rarely been transferred to FSM government staff who could continue this work independently. On those occasions that local staff has gained a certain degree of competence in such endeavors, they have found better job prospects elsewhere. In fact, EMPAT's tenure expired at the end of 2004. With the departure of EMPAT, there is likely to be a deficit of credible economic and financial data after this year.

The amended Compact with the FSM provides for a certain level of economic and financial aid every year through FY 2023, but places greater and more explicit emphasis than did the original Compact on expanding the productive capacity of the economy in a more orderly manner. This is to occur through improvements in public infrastructure, public health, public education, capacity building and other aspects such as institutional reforms that would make the FSM a more attractive market to overseas capital and skills.

Public Law 108-188 section 140(h)(1) requires this annual economic and financial report on the FSM by the United States Government. This will give the United States Congress information on, among other things, the use and effectiveness of United States financial,

program, and technical assistance; the status of economic policy reforms; and the status of the efforts to increase investment. This report, the first since the amended Compact took effect and based largely on data provided by EMPAT, is submitted in fulfillment of that requirement.

Economic and financial statistics of the FSM may present a mixed to favorable picture over the 1986–2004 period when the economic provisions of the original Compact were in effect. The United States Government and American taxpayers can take a great deal of satisfaction in the knowledge that the FSM, a political and economic entity made up of disparate peoples with distinct cultures, languages, and histories within small island communities, is an established, legitimate and dynamic democracy. Elections take place with citizen participation and tranquility.

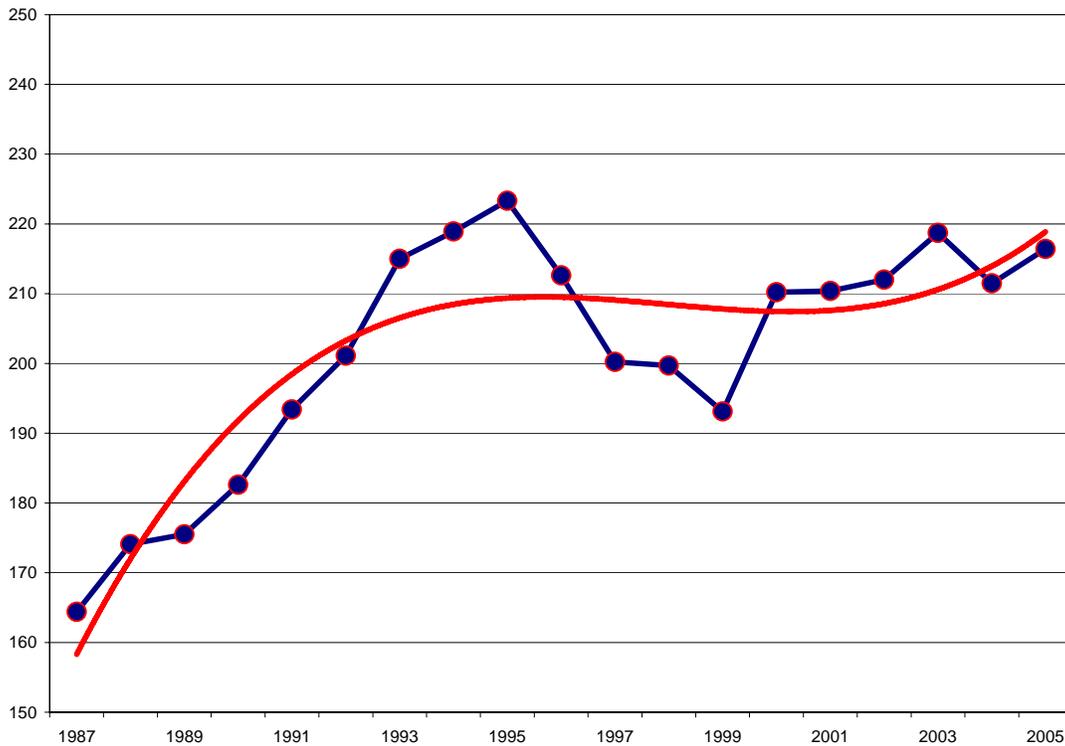
II. Economic and Financial Review of the FSM

The first stage of the implementation of the amended Compact was expected to boost the FSM economy in FY 2005. According to EMPAT's data, the FSM's GDP was an estimated \$225.1 million in FY 2004, down slightly from \$229.5 million in 2003, but projected to increase to \$233.6 million in 2005. Per capita GDP in the FSM was \$2,085 in 2004, lower than that in 2003, but projected to increase to an all-time high of \$2,157 in 2005. That level of per capita national income would put the FSM on par with Bulgaria, the Dominican Republic, Guatemala, Iran, Peru, and Thailand.

The original Compact took effect in 1986, but its economic impact did not begin to be felt until 1987. Looking at the period 1987–2004, however, it appears that although average by world standards, the FSM's overall economic performance is better than the average for most of the isolated and independent economies of the Pacific, which have generally stagnated or declined over the same period. FSM's economic history, evidence suggests two distinct phases of economic change: (a) the growth and prosperity phase, roughly from 1987 to 1995, when real (adjusted for inflation) GDP grew every year, and (2) decline and stagnation phase, roughly from 1995 to 2004, when real GDP either declined or stagnated.

Beginning in 1987, real GDP grew every year through 1995, with the growth rate averaging 3.9 percent a year. That growth rate was higher than the average for the independent economies of the Pacific. Per capita real GDP, a measure of the average comparative standards of living, increased during six of the eight years, and its growth rate averaged a healthy 1.9 percent annually in 1987–1995. To put it differently, the standard of living of the average FSM resident improved almost every year in 1987–1995, with the exceptions of small decreases in 1989 and 1994.

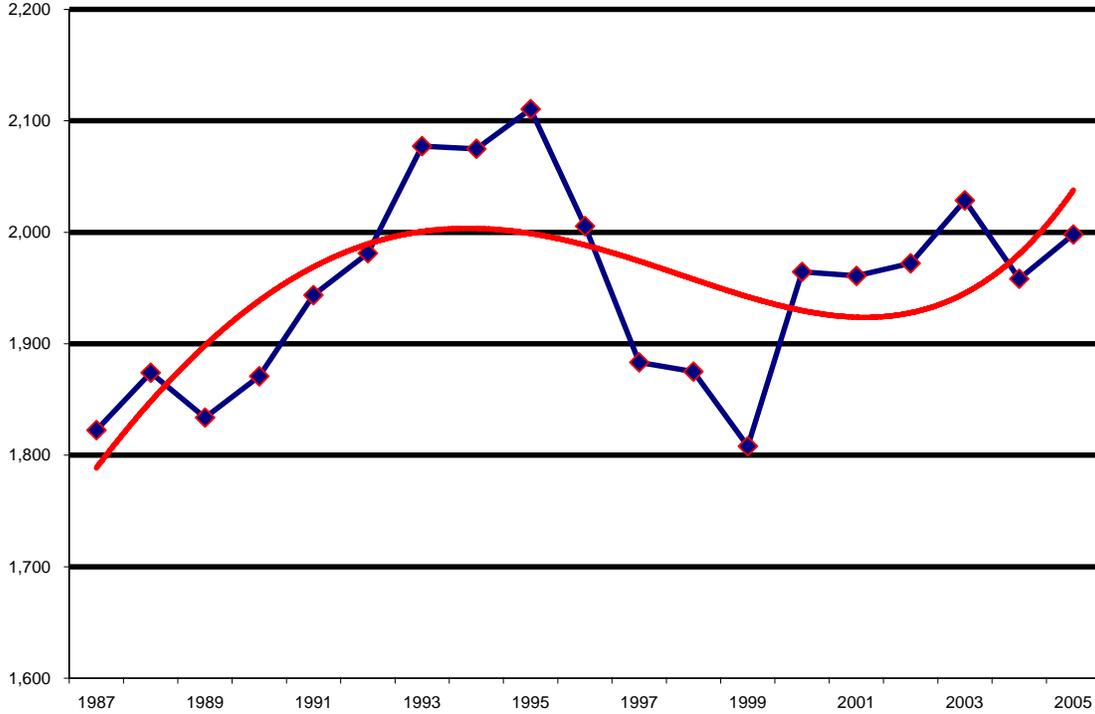
FSM Real GDP
(Millions of 1998 Dollars)



In part, because of built in step-downs in Compact funding and, in part, because of factors such as lower than expected growth in the private sector, the economy took a turn for the worse in 1996 and continued to decline for four consecutive years. Real GDP declined a significant 4.8 percent in 1996, followed by yet a larger loss of 5.8 percent in 1997 and further declines in 1998 and 1999. As a result of this reversal of collective fortune, the FSM’s real per capita GDP in 1999 was about where it had been in 1991. A strong but short-lived rebound occurred in 2000 when real GDP increased a remarkable 8.9 percent, only to be followed by smaller gains, ranging from 0.1 to 3.2 percent, in 2001–2003. These gains elevated real GDP to where it had been in 1994, the year before the peak in the FSM’s GDP. However, even with the projected growth in FY 2005, the FSM’s real GDP will be smaller than it was in 1994 or 1995.

The decline and stagnation in the 1996–2004 period can also be seen in real per capita GDP. Real per capita GDP peaked at \$2,111 in 1995 and declined or stagnated during most of 1996–2004, ending the period of the original Compact with a real per capita GDP of \$1,958 in 2004 (projected to rise to \$1,998 in 2005). In 2004, the FSM’s real per capita GDP was 7.2 percent lower than it was in 1995. On a favorable note, total real GDP has increased steadily, although modestly, since 1999, and it appears to be on its way back to the mid-1990s level. If the amended Compact’s provisions are accompanied by reforms in the institutional structure that would make the FSM an attractive market, there is a good chance that the FSM’s total output could surpass its previous peak.

**FSM Per Capita Real GDP
(1998 Dollars)**



During the 1987–2004 period, the FSM’s consolidated government finances also reflected two phases, but they were not as clearly defined as they were with respect to total output. Beginning in 1987, the FSM’s consolidated financial statement showed a surplus of \$38.0 million, followed by a larger surplus of \$39.0 million a year later. Two more years of surplus followed until the balance turned into a small deficit of \$1.1 million in 1991. Four more years of deficit followed. In 1996–97, there were small surpluses, each less than \$1 million. Relatively large deficits, ranging from \$14.1 million to \$19.6 million, occurred in 1998–2001, which were followed by two years of surplus in 2002 and 2003, only to return again to deficits in 2004, as well as a projected shortfall in 2005.

Given the peculiar nature of the FSM’s financial structure, where most of the public sector funding has come from the Compact, it may have been expected that revenue and spending would have been more in line with each other and shown a more predictable pattern over the years. Weak financial management, one of the dilemmas throughout the original Compact period, was only a part of the explanation. Uncertainty built into any financial management plan, regardless of the degree of competence of planners and governments, and the differences in practices and levels of competence within the four states have often spilled over to the national financial management scheme. However, it was mainly because of the weak financial management practices during the period of the original Compact that the amended Compacts incorporate more rigorous accountability

measures. With control of the amended Compact funds allocation residing with the United States majority on the Joint Economic Management Committee, as opposed to the arrangement under the original Compact when the FSM government made both allocation and spending decisions, there is greater likelihood that financial management will improve.

The FSM's employment data also tell a story that is in line with the economic and financial statistics. Total employment in the FSM increased every year, although sometimes by small increments, in 1987–1995. It rose from 12,209 to peak at 16,003. Beginning in 1996, total employment declined for three consecutive years, reaching a level it had been in 1991. Small gains followed in 1999–2002, but they turned into losses once again in 2003–2004. In 2004, total employment was where it had been in 1992–93.

A significant change in employment during the 1987–2004 period was the decline in public administration (government) employment as a share of the total. In 1987, public administration accounted for 61.0 percent of the FSM's total employment. Even during the growth and prosperity period of 1987–1995, when both total output and employment increased, government's share of employment decreased steadily from 61.0 percent to 49.0 percent. Government's share of employment continued to decline through the economic decline and stagnation phase when it reached an all-time low of 42.7 percent in 2004. That employment continued to decline as a share of the total during the entire 1987–2004 period is a reflection of the realization that a bloated and inefficient public sector had to be brought in line with economic and financial realities. Still, government's share of employment is much larger than in most market economies.

An important and potentially destabilizing force in the FSM economy is the low ratio of formal employment to population. Only 13.5 percent of the population was employed in 1987, with employment being defined as work for pay. In 1995, the peak of the business cycle, this ratio rose to 15.1 percent, a record. In 2004, the ratio was 14.0 percent, not that much different from that in 1987.

It should be pointed out that subsistence economy accounts for a relatively large part of the total economy, averaging 15.0 percent of GDP through 1987–2004, with small variations from year to year. Although there is no information on how to translate the market value of subsistence economy to formal employment, it is safe to say that it accounts for a significant share of employment. Still, the ratio of employment to population is lower than in most market economies.

III. Economic Reviews of the States of the FSM

Chuuk and Pohnpei show patterns of economic growth similar to that of the FSM. Perhaps it may be more accurate to say that the FSM's economic performance in 1987–2004 is more a reflection of Chuuk and Pohnpei than that of all four states put together. Chuuk's real GDP increased steadily from \$56.6 million in 1987 to \$69.2 million in 1995. It contracted for three years thereafter until it began to rise again in 1999 and

continued to gain until it reached \$64.6 million in 2003, the last year for which Chuuk GDP data are available.

Kosrae, the smallest state in terms of population, experienced growth in the 1987–1994 period, lost some ground in 1997–2000, but regained momentum earlier this decade to surpass the 1994 peak and reach a new high in 2001. However, it lost ground again in 2002 and 2003 when it finished with a real GDP that was lower than 2001 but higher than that in 1994.

Pohnpei, not only the most powerful state economically but also the seat of the national government, shows a pattern similar to that of Chuuk and the FSM as a whole. Real GDP increased steadily from \$67.7 million in 1987 to \$104.2 million in 1995, but was down to \$99.1 million in 2003.

Yap, the third largest of the four states in terms of population, had the most distinctive economic record in 1987–2004. Its real GDP was \$24.2 million in 1987, \$32.1 million in 1995, rose to a record \$37.9 million in 1998, but declined to \$36.6 million in 2003. It is the only state of the FSM that showed relatively steady gain in real output during the entire 1987–2004 period.

IV. Prospects for Economic Growth: Tourism

Despite its increase as a share of GDP, which rose from 23.0 percent in 1987 to 28.6 percent in 2004, the FSM's private sector is a relatively small piece of the economic pie. One industry that has played a critical role in increasing the private sector in small and isolated economies of the Pacific is tourism, especially in markets near main transport routes, such as Guam and Saipan. The FSM's tourism statistics reflect, quite realistically, the difficulties associated with small and remote markets, especially those with tourist facilities that are not considered regionally competitive.

Tourist traffic has been erratic and unpredictable in recent years. In 1996, total arrivals numbered 18,159, but dropped to 14,275 in 1998, the peak of the Asian financial crisis. Arrivals climbed back to reach 20,038 in 2000, reflecting the post crisis recovery in East Asia. They dropped again in 2001 to 15,494, perhaps because of the effects of the terrorist attacks on the United States, only to rise again to 18,700 in 2003 and dropping once again to 16,092 in 2004. What these numbers show, apart from the variations connected to regional economic and financial realities, is how small and unpredictable the FSM's tourism has been.

With the exception of Chuuk, which is just over an hour of flight from Guam, the other FSM states are off main regional transport routes. This makes it costly to fly to the islands and inter island transport is dependent upon a small number of commercial carriers. Tourism suffers from rudimentary facilities, even in the national capital on the Island of Pohnpei. The FSM still does not have a world-class hotel with meeting and other facilities. Finally, tourism offerings are limited with few attractions for mainstream

tourists. The market now focuses on adventure tourists, primarily divers and sport fishermen, from Asia and North America.

Business travelers provide another potential market. The Compact provides that, for purposes of Internal Revenue Code section 274(h)(3)(A), the FSM is included in the “North American Area” for purposes of the allowance of deductions for foreign conventions. Deductions for foreign conventions, meetings, or seminars are otherwise generally disallowed under the Internal Revenue Code, unlike events occurring in jurisdictions included in the “North American Area.”

The question of whether tourists follow facilities or vice versa has been the topic of local discussion for decades. With the certainty of Compact funding, some would argue, there has been little financial incentive to create tourist facilities that would bring more affluent tourists and, therefore, more private activity to these islands. More study is required on tourism to examine the issues of transport routes, the effects of new seating capacity, and the absence of tourist-class facilities.

V. Prospects for Private Sector Growth

Since the days of the Trust Territory of the Pacific Islands, the FSM private sector has been a secondary economic contributor with the public sector the primary engine for growth. Unlike economies of the 50 States and others where the private sector drives the economy and supports a certain level of government, in the FSM, the public sector has thus far been the driving force. Although the public sector’s share of the economy has declined over the last 17 years, government is still the driving force and will remain so unless major changes are made to alter this route into the economy of the future. It should be recognized, however, that market reforms to make the institutional structure more efficient and transparent, and improved infrastructure, would go only a certain distance. With physical realities remaining the same, regardless of the state of technology, expectations for private sector growth have to be adjusted to physical and institutional realities. Isolation, small mass, and limited land constrain the potential for most economic activities.

The FSM faces a fundamental problem in that its agriculture and farming sectors lack comparative advantage. Tourism offers limited potential.

Among the options to reduce pressure on the limited resources and fragile ecosystems in the islands is migration to the United States and its territories allowed under the original and amended Compacts.

Migration from the Freely Associated States

Migration from the freely associated states (FAS) to the United States and its territories began after the Compact took effect in 1986, but it did not get much attention until recently when Hawaii, Guam and Commonwealth of the Northern Mariana Islands

(CNMI) raised concerns about the cost of public services for migrants from Micronesia. These concerns became the basis of funding to these United States jurisdictions that is a part of Public Law 108-188. Based on 2003 data, there were 20,808 Micronesians in the United States island areas, with the following distribution:

Hawaii	7,297
Guam	9,931
CNMI	3,570
American Samoa	10

(Migrants to the mainland United States have not been enumerated, but may be expected to equal or exceed those in the island areas.)

As these numbers show, Micronesian migrants to the United States and its territories, although not a large number or a significant portion of all immigrants, are a large percent of the population of the area. The total of 20,808 is about 11.5 percent of the total population of the FSM, the RMI and Palau. Thus far, the bulk of the migrants are coming from the FSM, especially Chuuk; it is expected that future trends in Micronesian migration are likely to mirror the past.

The growing community of Micronesian migrants in the United States may result in certain advantages. First, those leaving Micronesia work in the United States and perhaps earn more than would be possible at home. Migration also reduces the pressure on fragile environments of the islands. Second, and more important, Micronesians working in the United States send money back home to support family and communities. Remittances from overseas may become an important future source of income that contributes to economic growth and development for those who choose to stay. The Compact obligates the governments of RMI and FSM to register all labor recruiters and require that they inform United States-bound FAS workers of their rights under United States law.

Republic of the Marshall Islands (RMI)

I. Background

The government of the RMI has not developed the capacity to generate and disseminate macroeconomic information. Basic statistics on the various components of the economy, the tax base, labor force, employment, wages and salaries, pensions and other commonly followed factors are being compiled, but they are often dated and incomplete. World and regional organizations such as the International Monetary Fund (IMF) and the Asian Development Bank (ADB) produce their own assessments of economic growth and development conditions through field visits to the country. This report is based mainly on the most recent ADB and IMF economic and financial assessments.

A succession of foreign advisors, including teams funded by ADB and the United Nations Development Programme, has been employed over the years to generate and

disseminate macroeconomic data and offer economic and financial advice to the national government. Despite good work by outside entities, the skills to do this work have rarely been effectively transferred to RMI government staff who could continue this work independently. ADB has a two-year technical assistance grant to strengthen the RMI's recently reorganized Economic Policy, Planning and Statistics Office (EPPSO), which is now a part of the Office of the President. The rationale behind attaching EPPSO to the Office of the President of the RMI is to make it more visible and perhaps a more viable organization to monitor economic progress and make policy.

Institutionalizing the efforts to produce economic and financial data and policy advice requires time and permanent commitment of resources. Meanwhile, both the RMI and United States governments are required to report on the RMI's progress every year through 2023. Assistance for moving more rapidly toward self-reliance in economic and financial data and policy analysis and advice may be found within the amended Compact's provision for capacity building. Putting those resources together with those from others, such as the ADB, would make it possible to establish a collaborative mechanism and fund it consistently. As this effort progresses and becomes a part of the institutional structure, it would make economic and financial data a part of the public good that the government of the RMI offers its citizens and others.

The amended Compact with the RMI provides for a certain level of economic and financial aid every year (through FY 2023), as did the first one, but places greater and more explicit emphasis than did the original Compact on expanding the productive capacity of the economy in an orderly manner (through FY 2023). This is to take place through improvements in public health, public education, public infrastructure, capacity building and other aspects such as institutional reforms that would make the RMI a more attractive market to overseas capital and skills. Public Law 108-188 section 140(h)(1) requires this annual economic and financial report on the RMI by the United States Government. This will give the United States Congress information on, among other things, the use and effectiveness of United States financial, program, and technical assistance; the status of economic policy reforms; and the status of the efforts to increase investment.

II. Blending Democracy with Tradition

Economic and financial reviews of the RMI reveal a challenging picture in the years 1986–2004 when the economic provisions of the original Compact were in effect. However, the United States Government and American taxpayers can take a great deal of satisfaction in the knowledge that the RMI is a dynamic democracy. The original Compact was designed to build on and institutionalize a representative self-governance system that had begun to take shape during the United Nations Trust Territory of the Pacific Islands in the 1950s, 1960s, and 1970s, which the United States administered. Democracy has flourished in the RMI, despite the challenges of a hierarchical traditional social structure, small atolls and islands with scattered populations, and few resources other than the Pacific Ocean. National and local elections take place with citizen participation and tranquility.

One of the most remarkable chapters in the evolution of the RMI's modern democratic institutions occurred in 1999, when, for the first time, commoners in the RMI parliament (the Nitijela) successfully challenged traditional leaders for power and leadership through the ballot box. Discontent with the traditional leadership's management of Compact funds and other resources and, therefore, the economy, had grown over the years, but it was believed that since traditional leaders had social, political, and economic leadership duties, obeying their commands was a natural extension of the social order. Transfer of power from traditional leaders to commoners was unprecedented and expected to generate some level of unrest.

Taking advantage of the RMI's democratic processes, opposition forces formed a new alliance and won the 1999 election. Once the voters voted and the election process was complete, traditional leaders stepped aside and accepted the outcome. This type of peaceful transfer of power from traditional leaders to nontraditional political leaders has occurred in the Pacific rarely. Citizens of the Marshall Islands take pride in their constitution. Four years later, the political party that replaced the traditional leaders in 1999 was returned to office with yet a larger majority in the Nitijela in November 2003, reaffirming the faith the RMI people have in their democracy.

The enduring legacy of United States involvement in the RMI and, for that matter, in the rest of Micronesia, has involved the blending of local traditions and cultures with modern democratic institutions. The RMI's political system generates the political and social stability within which the Marshallese, their institutions and markets can work to achieve a greater degree of prosperity. Using democracy to heighten prosperity is a challenge in the small, isolated, and traditional markets of the Central Pacific, but one which the people of the RMI, with United States support under the Compact, are on track to achieve.

III. Economic and Financial Review

In a report following its "Article IV" consultations and economic and financial review of the RMI in early 2004, the IMF reported:

During 1995–2001 (the latest official data), real GDP and real per capita GDP contracted by nearly 25 percent and 35 percent, respectively. Employment has not increased since the late 1980s. Between 1988 and 1999, the unemployment rate jumped from 12 percent to over 30 percent and is estimated to have remained broadly unchanged.¹

This state of the economy, as the IMF noted, is the product of a unique set of circumstances. The RMI relies heavily on external flows of funds, (Compact and others from the United States, and some from other countries and global institutions). These sources have averaged around 60 percent of the gross domestic product (GDP) of the

¹ International Monetary Fund, "IMF Concludes 2003 Article IV Consultation with the Republic of the Marshall Islands," Public Information Notice (PIN) No. 04/8, February 13, 2004.

RMI since 1986 when the original Compact took effect. When grants declined in real terms (adjusted for inflation), partly because of built in step-downs in Compact funding, economic growth slowed and “real per capita income fell below the pre-independence level.” Also contributing to economic and financial decline was retirement of some of the external debt that the RMI had incurred on commercial terms in the mid-1980s against future payments of the Compact. The effect of these developments, as the IMF reports points out, was a decline in the average standard of living in the RMI. The IMF adds that human development indicators fell behind those in other middle-income economies and outer atolls suffered from a high incidence of poverty.

In a comprehensive report by the Enterprise Research Institute (ERI) for the ADB on the RMI’s private sector assessment, ERI listed the “Main Issues” as a stagnant economy, low rate of return on capital, costly business environment, concentrated economic power, undeveloped financial markets and limited business and government consultation.² As accurate and timely as this assessment appears to be, there is little new in it. The physical and institutional constraints within which an economy like the Marshall Islands must operate have been studied quite thoroughly over the years. The question is: are there new solutions for well-known existing challenges? The answer is far from clear.

Another comprehensive and more recent report by ADB, “Country Strategy and Program Update (2005–2007), Marshall Islands”³ presents more recent evidence on economic conditions and the policy environment and how it foresees the near future. The study reports that real GDP increased one percent in FY 2003, following a 4.0-percent growth in 2002. GDP was projected to increase another 3.0 percent in 2004, “as a result of increased budgetary expenditures in line with the new Compact provisions.”⁴ Among the positive developments contained in the report were increased revenues for copra because of higher prices and increased shipments from the fish processing (loining) plant in Majuro, based on 2002 data.

Since this report was compiled the fish processing plant, the largest private sector employer in the RMI, which employed 500–600 persons at its peak, closed. It has remained closed and is in danger of permanently shutting down because of a variety of financial problems. When the plant opened earlier in the decade, it was the first major commercial enterprise to take advantage of the RMI’s abundant fish resources. The closing of the fish processing plant is among the most significant adverse developments in the Marshall Islands in recent years. Another serious problem involves the College of the Marshall Islands’ potential loss of accreditation, and therefore, loss of United States funding.

² Enterprise Research Institute, *Republic of the Marshall Islands Private Sector Assessment: Promoting Growth Through Reform*, May 2003 (Version 2.0)

³ Asian Development Bank, *Country Strategy and Program Update (2005-2007, Marshall Islands)* (Draft), May 2004.

⁴ ADB, *Country Strategy and Program Update (2005-2007, Marshall Islands)* (Draft), May 2004, p. 2.

IV. Economic and Financial Outlook

The average elevation from sea level in the Marshall Islands is about seven feet and most of the soil of the relatively flat atolls and islands is too salty to produce much food and fiber. Tropical crops and trees that have adapted to the salty soils, such as coconut palms, do not produce much economic value to compete with jobs in the money economy. These realities severely limit production in traditional agriculture.

Given these constraints, the RMI should focus on encouraging the return to growth in the RMI's fishing and fish processing. The Marshall Islands and other Pacific economies have been selling fishing rights to foreign fleets for decades, but those rights generate modest sums of money and almost no local value added other than purchase of local fuel and supplies. The loining plant in Majuro generated local value added in wages and salaries and other benefits that go with formal work for pay. The potential demise of the plant raises questions about the RMI's ability to benefit from its most abundant natural resource.

Production of Copra, the dried white flesh of a coconut, continues, although its share would most likely decline as other activities present more attractive options, especially to those with education and skills.

Tourism represents a possibility for new growth. Specialized tourists such as divers, sport fishing enthusiasts, and others who normally travel in small groups but have more money to spend per person per trip, represent a potentially lucrative market. Business travelers provide another potential market. The Compact provides that, for purposes of Internal Revenue Code section 274(h)(3)(A), the RMI is included in the "North American Area" for purposes of the allowance of deductions for foreign conventions. Deductions for foreign conventions, meetings, or seminars are otherwise generally disallowed under the Internal Revenue Code, unlike events occurring in jurisdictions included in the "North American Area."

The RMI's most valuable assets are its location and ties to the United States. The RMI's contribution to United States strategic assets and facilities is a valuable comparative economic and strategic advantage that has been successfully translated into an income stream. The Compact offers an additional significant advantage to RMI citizens, the right to travel to and reside in the United States. Also, islanders living in the United States are a valuable source of income as they send money home to relatives.

The United States hopes to contribute to economic and financial stability through the amended Compact with the RMI. With upgrades to its institutional structure, including the provision of current and reliable economic and financial data, the RMI economy could show growth going forward.

With stringent financial resource allocation controls written into the amended Compact, the RMI's financial situation has the potential to improve. For instance, the Joint Economic Management and Financial Accountability Committee, on which the United

States has the majority vote, can play an instrumental role in both allocating and managing United States assistance in a manner that reduces misallocation and mismanagement. With financial controls in place, it is expected that increased benefit from Compact funds will accrue to the people of the Marshall Islands over the next 20 years.

(B) Use and Effectiveness of United States Financial, Program and Technical Assistance

The FSM and the RMI receive significant financial, program, and technical assistance support from the United States Government. The amended Compacts of Free Association provide the largest proportion of assistance through sector grants, trust fund transfers and other support, but the two governments also receive annual program support from a variety of Federal sources. In addition to administering Compact funds, the United States Department of the Interior continues to provide discretionary grants for technical assistance, operations and maintenance of public infrastructure, and to protect coral reefs. Although most of the Federal financial support formerly received from program grants of the United States Departments of Education and Labor, and about half of the support formerly received from the United States Department of Health and Human Services, has been rolled into the Supplemental Education Grant (SEG) created by the Compacts, other Federal agencies still support the FAS.

Compact Sector Grants

In FY 2004, the United States Department of the Interior managed \$76 million in direct financial assistance to the FSM. The RMI received \$33.1 million. While the awards are important in terms of total per capita aid provided by the United States to the two former components of the Trust Territory, the grants themselves mark the beginning of the assistance provided under the amended Compacts and signal a significant departure from how the countries received, used and accounted for funds during the past 17 years.

Changes in Methods of Allocation, Uses, and Monitoring

Under the original Compact from 1986 to 2003, direct United States assistance supported general governmental operations and capital development with few controls, restrictions or earmarks. Under the amended Compacts, beginning in FY 2004 and through FY 2023, three new elements are meant to enhance accountability, safeguard the effective use of funds, and strengthen the basic foundation needed for economic stability and future growth:

1. Targeted Uses of Direct Financial Assistance

The amended Compacts institute a focused approach to funding. Grants managed by the United States Department of the Interior now are for only a limited array of government sectors and, within those sectors, only for specific aims.

Education: Education sector grants support and improve the primary, secondary, and postsecondary educational systems of the governments and develop the human and material resources necessary to perform these services. Emphasis is on advancing a quality basic education system by increasing primary and secondary student achievement as measured by performance standards and assessments appropriate to the two countries; providing secondary education or vocational training to qualified students; improving management and accountability within the educational systems; raising the level of staff quality; and, improving the relevance of education to the needs of the economy.

Supplemental Education Grant: In addition to the education sector grant, each government will receive an annual Supplemental Education Grant (SEG) that provides funding in lieu of certain program grants previously awarded by the United States Departments of Labor, Health and Human Services, and Education. These grants are to support the educational goals and objectives of each government's Development Plan and for additional direct services at the local school level focused on certain activities. The SEG funds are not to be taken into account when satisfying the priority to be given to the education and health sectors when awarding sector grants.

Health: Health sector grants support and improve the delivery of preventive, curative, and environmental health care, and develop the human and material resources necessary to provide health services. The sector's priority is to establish sustainable funding mechanisms for operating community-based systems that emphasize prevention, primary care, mental health, and substance abuse prevention, as well as the operation of hospitals and dispensaries/clinics to provide secondary care at appropriate levels and reduce the reliance on medical referrals abroad.

Public Infrastructure: Public infrastructure grants are to be used to assist the governments in their efforts to provide adequate public infrastructure. The highest priority projects are primary and secondary education capital projects and projects that directly affect health and safety, including water and wastewater projects, solid waste disposal projects, and health care facilities. Secondary priority areas are economic development-related projects, including airport and seaport improvements, roads, sea walls, and energy development that cannot be funded through existing rate structures.

Private Sector Development: Private sector development grants support the efforts of the two governments to attract new foreign investment and increase indigenous business activity by vitalizing the commercial environment; ensuring fair and equitable application of the law; promoting

adherence to core labor standards; and, maintaining progress towards the privatization of state-owned and partially state-owned enterprises and engaging in other reforms. Sector grant priorities are advancing the private development of fisheries, tourism, and agriculture; employing new telecommunication technologies; and, analyzing and developing new systems, laws, regulations, and policies that foster private sector development.

Public Sector Capacity Building: Public sector capacity building grants are to support efforts to build effective, accountable, and transparent national and local governments and other public sector institutions and systems. Funding priorities are improving economic planning, financial management, auditing, law enforcement, immigration controls, the judiciary, and the compilation and analysis of appropriate statistical indicators. The goal is to ensure that both governments have the means to carry out essential functions and fill essential positions with qualified personnel.

Environment: Environment sector grants support government efforts to protect the country's land and marine environment and to conserve and achieve the sustainable use of natural resources. Allowable activities include the ongoing development, adoption and enforcement of policies, laws and regulations; the reduction and prevention of environmental pollution and degradation; the protection of biological diversity; the establishment of conservation areas; environmental infrastructure planning, design construction and operation; interaction and cooperation with nongovernmental organizations; the promotion of increased environmental awareness; and, the promotion of increased citizen involvement in conservation.

Although the majority of these new targets for financial assistance will not yield direct or immediate economic returns, they are enablers of progress. They allow the countries to pursue priorities that, over time, have the greatest potential to create an enhanced and sustainable climate for economic development. Because education, health, and infrastructure development are basic needs in both countries and form the foundation for economic growth, they are the clear priorities and are the sectors that received the lion's share of direct financial assistance in FY 2004. By virtue of the amended Compacts, this emphasis will apply to annual grant assistance through FY 2023 and to expenditure of annual Trust Fund revenues thereafter.

2. Joint Decision Making and Consultative Monitoring

Another major element absent under the original Compact, and newly incorporated in the amended Compacts, is the creation of bilateral economic management committees. The Joint Economic Management Committee

(JEMCO) formed for the FSM and the Joint Economic Management and Financial Accountability Committee (JEMFAC) formed for the RMI, respectively have two members from the FAS country and three from the United States (from the Department of the Interior, the Department of State, and the Department of Health and Human Services). Their purview includes the review and approval of grant allocations among and within sectors, performance objectives, and assessment tools for the upcoming FY. They also have the authority to attach special conditions to grant awards to improve program performance and fiscal accountability. In addition, the United States appointees to these committees are required to consult with the Secretary of Education regarding the objectives, use, and monitoring of United States financial, program, and technical assistance made available for educational purposes.

Forerunners of these committees met in 2003,⁵ which led to the first grant awards of FY 2004. The work of the committees includes addressing issues of fiscal stability, establishing allocation levels and uses of grants that keep to the priorities of the amended Compacts, and identifying ways to encourage and facilitate key structural reforms that maximize the impact of Compact dollars over time. Supported by the Office of Insular Affairs, the committees maintained oversight throughout the FY to:

- (1) monitor each country's progress toward sustainable economic development and budgetary self-reliance;
- (2) track development assistance from all sources as it relates to the allocation of financial assistance under the amended Compacts;
- (3) review audit progress and actions taken to reconcile problems and qualified findings;
- (4) evaluate performance outcomes and financial reports; and
- (5) review trust investment reports.

Clearly, the two committees have been and will continue to be a critical venue for policy continuity and for giving more systematic and consultative attention to the use and effectiveness of Compact financial assistance than had been possible in the past.

3. Accountability and Transparency

⁵ At that time, the amended Compacts of Free Association, which provided for the creation of JEMCO and JEMFAC, had not yet come into effect. However, because of the need to properly allocate the Compact grant funds for FY 2004, the parties, prior to the start of FY 2004, convened committees that functioned as the proposed JEMCO and JEMFAC were to function. Thus, the United States and FSM convened the "Anticipatory Task Force" in August 2003 to allocate and attach conditions to the FY 2004 Compact grants. The United States and RMI convened a similar committee, which was designated as the Joint Economic Management and Financial Accountability Committee (that is, the same name chosen for the permanent bilateral committee under the amended Compact), to allocate RMI's FY 2004 Compact funds in September 2003. JEMCO and JEMFAC, as established by the amended Compacts, met for the first time in August 2004.

New fiscal procedures jointly crafted by the United States, the RMI, and FSM govern the implementation of the amended Compacts. In general, financial disbursements fall under the same terms and conditions applicable to United States State and local governments. The provisions, however, are decidedly performance-oriented and, as such, meant to stimulate more effective spending and greater accountability in terms of expanded and regular reporting, and more frequent bilateral consultation. As a last resort, the procedures also spell out enforceable remedies for noncompliance with grant terms and conditions.

Under the amended Compacts, the requirement for regular medium-term planning by the countries is expected to result in more clearly defined scope and objectives for funds allocated to the sectors. Built into the six sector grant awards is the necessary authority to ensure that reasonable progress is made toward country goals.

Adequate resources to implement the amended Compacts are the key to the effort. In October 2003, the Office of Insular Affairs opened a dedicated field office in Hawaii to administer and monitor direct Federal assistance to the FSM and the RMI and to track progress, on a day-to-day basis, toward the achievement of bilateral policy and program aims. Staffing the office is a full complement of five senior specialists who have specific program and financial expertise relevant to the amended Compacts. They are augmented by two additional professionals, one assigned to the United States Embassy in Majuro in the RMI and the other assigned to the United States Embassy in Pohnpei in the FSM.

In FY 2004, field staff primarily turned their attention to two areas. One focus was to oversee the sector grants and monitor performance and expenditures. The other was to ensure that, under the amended Compacts, both the RMI and the FSM have the capacity to track the progress and the soundness of their financial management system, and would initiate actions to address weaknesses.

FY 2004 Sector Allocations for the FSM and Uses

The following is a breakdown of allocations to the FSM by sector and, within sectors, by government entity:

	Education	Health	Infrastructure	Capacity Building	Private Sector Dev.	Environment
National Government	4,324,122	553,613	No allocation	4,287,697	513,091	79,477
Chuuk	8,140,265	4,691,707	No allocation	2,853,813	1,338,874	378,394
Kosrae	1,883,853	1,326,663	No allocation	1,013,866	795,261	302,523
Pohnpei	7,373,651	5,989,461	No allocation	1,676,163	525,423	666,944
Yap	4,243,681	2,881,672	No allocation	1,831,307	613,470	595,854
	25,965,572	15,443,116	17,119,155	11,662,846	3,786,119	2,023,192

Education

Education was one of only two amended Compact sectors that established national outcome measures. With student test scores chosen as overall performance targets, the FSM National Government and the four states began the process of identifying and producing baseline information that will allow comparisons from year to year and over time. This work needs to be completed, and supporting data systematically collected, before a quantifiable determination of progress is possible.

Money allocated to the sector supported basic recurring operations, ranging from administrative support and teacher salaries to the purchase of supplies and instructional materials. At the FSM National level, staff focused on high school accreditation and the adaptation of Western Association of Schools & Colleges (WASC) criteria, and investigated ways to improve teacher qualifications and basic certification. In Chuuk, the education department downsized from 6 to 3 divisions and consolidated schools, decreasing the number from 102 to 75. Kosrae continued to focus on standardizing its curriculum and teacher certification. Pohnpei instituted over 10,000 contracts between parents, teachers, and students as part of its effort to improve school management and student performance. After Typhoon Sudal struck Yap in April 2004, the state grappled with the massive task of repairing and rebuilding damaged classrooms. By September 2004, only five schools had reopened.

Health

Health was the other FSM amended Compact sector that attempted the identification of unified performance measures, targets, and baselines before the start of FY 2004. Its three grant performance areas include:

- (1) the improvement of primary care services by increasing dispensary utilization, decreasing the use of hospital outpatient clinics for basic care, and decreasing the incidence of certain diseases;
- (2) the improvement of secondary care (hospital) services through increasing the availability of drugs and supplies, upgrading diagnostic equipment, decreasing infant mortality, lowering the prevalence of diabetes and hypertension, and decreasing medical referral expenditures; and
- (3) the development of sustainable health care financing mechanisms including fees and insurance.

In July 2004, measures for teenage smoking and basic sanitation were added.

Until the FSM National Government and the states complete the refinement of these measures, establish firm baselines and agree to appropriate medium term targets, there will be no coherent longitudinal framework by which to evaluate the effectiveness of the Compact's health investment.

The \$15,443,116 health sector award represented 20.3 percent of all Compact financial assistance provided to the FSM in FY 2004. As in the case of education, funding primarily supported regular recurring operations. For most hospitals, direct assistance enabled the improvement of supply inventories that alleviated chronic shortages and the restoration of minimally adequate diagnostic capacity. The overall impact of these and other service or organizational enhancements to improved health status and disease outcomes is, in part, dependent on the safety and adequacy of the sector's physical infrastructure. Except for relatively small non-Compact funded renovations, capital improvements related either directly or indirectly to health have yet to be addressed in any systematic way.

Public Infrastructure

JEMCO allocated approximately \$17 million for infrastructure improvements and maintenance in the FSM in FY 2004. The amount represented only 22 percent of all annual grant assistance provided under section 211 of the United States-FSM Compact, as amended. This proportional share falls below the 30 percent floor envisioned by Congress as a necessary investment to spur economic activity. Mindful of this sense of Congress, JEMCO in August 2004 adopted a resolution that the allocation of 30 percent of Compact funds to public infrastructure should be achieved in FY 2006.

Although JEMCO allocated \$17 million for construction of public infrastructure, it did not approve any of the specific projects initially proposed by FSM. JEMCO took this action for two reasons. First, the majority of the project proposals clearly fell outside the priorities specified in the amended Compact. Second, the FSM did not have a nationwide infrastructure development plan in place, as required, to guide priority setting, project selection and implementation. These conditions were not resolved in FY 2004. Consequently, no money was expended or obligated for public infrastructure. The entire FY 2004 grant allocation remains available for use in addition to new FY 2005 funds.

Public Sector Capacity Building

The FSM received \$11,662,846 for the capacity building sector, an amount that represented 15.4 percent of all direct financial assistance for FY 2004. This was a proportionately larger amount than intended or foreseen by the negotiators of the amended Compact but necessitated by the FSM's apparent lack of local revenue to cover a range of government operations. From the outset, under the amended Compact, the United States delegates to JEMCO (and its forerunner, the Anticipatory Task Force⁶) made clear that the purpose of this grant was to *build* capacity in certain key functional areas, such as accounting, financial management, budgeting, auditing, and law enforcement. The United States delegates to JEMCO were concerned about the possibility that the grant might be used simply to maintain pre-existing capacity, or, worse, that the grant might be used as a general operating subsidy for government.

⁶ See footnote 5.

Notwithstanding the foregoing concerns, all parties recognized that the FSM did not initially have sufficient local revenue to support certain key public sector functions, and that preventing the FSM from using public sector capacity grant money to fund pre-existing operating expenses might result in a reduction in capacity in crucial areas. JEMCO therefore agreed to allow certain pre-existing operating expenses in core functional areas, such as those listed above, to be initially funded from the public sector capacity building grant subject to a five-year phase-out period. The public sector capacity building grant may otherwise be used for operating expenses in connection with the building of new capacity. For example, the grant may be used to pay the salaries of additional investigators for the public auditor's office, on the understanding that those salaries will be supported by local revenues rather than Compact funds after a reasonable startup period, and in no event beyond the five-year phase-out period.

Environment

The \$2,079,028 grant award represented 2.7 percent of all direct assistance under the amended Compact in FY 2004. Given the amended Compact's broad definition of the sector, the most basic issue concerning the use of this grant was the degree to which it could be used to fund recurring operations of agencies.

JEMCO specifically allowed the funding of recurring operating costs in FY 2004 in order to maintain and improve the effectiveness of agencies tasked with environmental oversight but required closer monitoring of performance. A clearer articulation of outcomes and baselines by the FSM is necessary before any attempt is made to measure the impact of activities funded under this sector grant.

Private Sector Development

The FSM received a grant award of \$3,786,119. The amount was approximately five percent of all direct Compact financial assistance in FY 2004.

The country's proposal on how the states would use the amount clearly overstepped the amended Compact's definitional parameters of the sector. Some governments intended to fund recurring operations that were only partially compatible with or were completely inappropriate to the goal of promoting the private sector. Most conspicuous were activities to continue government operations that perform commercial functions rather than emphasize private sector management.

As it did with the capacity building sector grant, the FSM asked for time to find other sources of revenue to cover the costs or to transfer commercial enterprises to the private sector. JEMCO agreed to a time-phased migration out of the inappropriate activities but only with the proviso that it be done according to an explicit plan. Initial monitoring found a wide variety of uses that have the potential to encourage private sector development. Evaluation of performance and any measurable impact on private sector growth will be the focus of reporting and monitoring in FY 2005 and beyond.

FY 2004 Allocations for the RMI and Uses

The following is a breakdown of sector grant allocations to the RMI and of the distribution of special Compact funding for Kwajalein Atoll (Ebeye Special Needs):

Sector Grant	Direct Financial Assistance	Ebeye Special Needs
Education	9,648,932	1,100,000
Health	5,894,448	1,000,000
Infrastructure	13,700,000	1,000,000
Capacity Building	0	0
Private Sector Development	356,620	0
Environment	200,000	200,000
	29,800,000	3,300,000

Education

During FY 2004, the RMI used Compact funds to make steady progress toward meeting the following seven national goals:

- Increasing the number of early childhood enrollees
- Establishing a quality primary education system
- Promoting school attendance
- Providing a quality secondary education system
- Increasing success rates among post secondary students
- Providing scholarships to qualified students
- Improving coordination between schools and vocational education providers

Long in the planning, the RMI Ministry of Education (MOE) launched its first year of kindergarten classes. It also provided training to elementary teachers on recently revised language arts and math performance standards used as a basis for testing of third and sixth grade students. Other significant activities included the creation of a database to track student and teacher absenteeism at all grade levels; the extension of classroom hours for core academic subjects; the opening of a National Vocational Training Institute; and the piloting of a teacher literacy test that the MOE will implement during the 2004–2005 academic year.

A troubled College of the Marshall Islands (CMI) received a final “show cause” notice from the Western Association of Schools and Colleges (WASC) that threatens its accreditation status and consequently its eligibility for approximately \$4 million in Federal education funds. This money accounts for nearly three quarters of the college’s annual budget. The loss of that revenue stream could spell the demise of in-country, post secondary education and training with spillover effects on economic development.

CMI had until November 2004 to provide evidence that it had addressed major administrative and financial problems and infrastructure deficits. Its staff and management:

- (1) revised all course outlines to incorporate student learning outcomes;
- (2) revised faculty and staff evaluation forms and procedures;
- (3) completed all overdue financial audits; and
- (4) partially completed a facilities master plan for the college.

In August, the Nitijela, the RMI's parliament, committed \$3 million annually to the CMI. The Nitijela is presuming that \$1 million of this would come from United States funds under the Compact, although the question has not yet been considered by the JEMFAC. The WASC found that the CMI made progress toward a more comprehensive approach to budgeting. In making that determination the WASC took into consideration funding support from the RMI Government at \$3 million annually through 2010.

Health

For FY 2004, the RMI received \$5,894,448 in Compact sector grant assistance. The amount represents approximately 44 percent of the country's \$15,756,334 health budget. The health sector also received an additional allocation of \$1,000,000 in Ebeye Special Needs money. Health-related capital projects funded through the Compact's infrastructure sector were valued at approximately \$2,722,292. This investment raised the projected health spending under the amended Compact for the FY to \$9,616,740.

Kwajalein Atoll Health Services received an allocation of \$3,325,516 from the total Compact grant award to manage and provide hospital care, public health programs, and primary health care to residents in its geographic service area. The balance of funds was allocated to the Ministry of Health in Majuro.

Compact funding covered recurring operational costs but also enabled the Ministry of Health to upgrade medical equipment, diagnostic services, and staffing. Outcome areas included:

- The provision of effective health care services as measured by indicators such as immunization rates, tuberculosis and leprosy rates, and dentition status rates;
- The provision of effective outer island health services as measured by access rates, staff competencies and the adequacy of health, transportation and communication infrastructure;
- The provision of effective hospital services (in-country service improvement and reduction of off-island medical referrals) as measured by indicators such as admission diagnoses and patient morbidity and mortality rates, staff qualifications, and the adequacy of pharmaceutical and biomedical equipment diagnostic and treatment capacities;
- The provision of efficient health care services and management for Kwajalein Atoll as measured by immunization rates, suicide completion rates, infant mortality, the DOT rate for tuberculosis treatment, and dentition status; and

- The provision of effective medical referral, personnel, and financial management as measured by indicators such as the number of referrals and cost savings per year, cost efficiencies in equipment purchases, and the matching of staff skills and workload.

The accurate measurement of progress over time will be contingent on work to establish baselines and track the relationship of activity-based budget outputs to broader sector outcomes.

Public Infrastructure

Before the amended Compact, the RMI established a policy to direct at least 30 percent of all annual United States direct financial assistance to infrastructure development. For FY 2004, the country requested and received an allocation of \$14.7 million for capital improvements and maintenance. This amount represented approximately 42 percent of all grant assistance provided under section 211 of the United States-RMI amended Compact.

To guide project selection, the RMI developed a comprehensive Infrastructure Development and Maintenance Program with complete descriptions, timelines, financial requirements and measurable indicators. In keeping with the priorities specified in the amended Compact, education received the largest portion (70 percent) of funding in FY 2004. The RMI also identified the health sector as a priority and dedicated considerable infrastructure funding toward the acquisition of capital equipment for Majuro Hospital and for improvements to outer island dispensaries.

Public Sector Capacity Building

The RMI did not request funds for capacity building in FY 2004.

Private Sector Development

The RMI received an allocation of \$356,620 for its private sector development sector grant. This amount, which represents approximately 1.0 percent of annual Compact financial assistance for FY 2004, was used to support activities of the following agencies and offices:

- The Marshall Islands Visitors Authority
- Small Business Development
- Land Registration

The main objectives of these entities are to develop a central data bank which lists land available for development, promote Marshallese products at the regional level, and encourage entrepreneurship through the support of small businesses. These activities and services satisfy the parameters of the amended Compact sector; however, measurement of

their impact in promoting private sector development is pending the adoption of clear outcome statements and baseline data.

Environment

For FY 2004, the RMI received an environment sector grant of \$400,000. Half of the sum came from section 211 funds and the other from the amended Compact's Kwajalein Special Needs set-aside. This amount represented approximately 1.1 percent of annual Compact financial assistance. Funds went to support the recurring costs of the RMI's Environmental Protection Agency (EPA) as the RMI's recipient entity.

Outcome areas included improving:

- Environmental health and water quality
- Coastal and land conservation and management
- Biodiversity conservation
- Waste and pollution
- Education and awareness
- Information management

Gauging the performance of EPA in supporting and facilitating the goals of the sector and in advancing the economic goals of the amended Compact is contingent on the development of clear outcome statements and baseline information.

Enewetak Food and Agriculture Program

In FY 2004 the RMI's Enewetak Local Government received a grant of \$1,620,000 to support a program to rehabilitate the atoll which was damaged by the United States' nuclear testing program. The cleanup of the atoll left the soil depleted and unable to support agricultural activity needed to support the population. The Enewetak program provides supplemental food for the community of about 800 people, replants vegetation and replenishes soil. The program was initiated in 1980 and was extended by the United States Congress in Public Law 108-188.

The Department of the Interior is working with the Enewetak Council to demonstrate the effectiveness of the program by tracking the area improved to support agriculture.

Department of the Interior Discretionary Grants

The FSM and the RMI continue to be eligible for the discretionary grant programs of the Office of Insular Affairs (OIA) of the Department of the Interior. Although the amended Compacts provide significant operational support in health and education and provides

funds for capacity building, both governments still have special short-term needs that can be effectively addressed by OIA's programs.

Technical Assistance

The OIA Technical Assistance Program provides support not otherwise available to the RMI and the FSM. The program allows each government to identify pressing needs and priorities, and to develop plans of action to mitigate these problems. Funded projects are focused to meet immediate needs in the short term and to assist the governments find longer term solutions. Many of the projects have a direct relation to improving accountability and performance under the new amended Compact requirements.

During FY 2004, grants were provided from General Technical Assistance for the following projects:

A. FSM

- Training for the Public Auditors to sharpen their skills for auditing of Compact and local funds—\$150,250.
- Training interns and staff in Accounting and Computer operations—\$70,000
- Support for an Economic Summit for the FSM to develop a Strategic Development Plan—\$100,000
- Small projects with the United States Department of Health and Human Services Centers for Disease Control and Prevention on healthcare issues—\$21,600
- GIS systems for support of economic development and land ownership issues—\$144,700
- Support for installation of machine readable passport system—\$89,000

Plans are now being made to procure and install a unified financial management system to service the FSM National and State Governments. This will allow the FSM to meet Compact financial reporting requirements in an easier and more organized fashion.

B. RMI

- Development and implementation of Performance Based Budget process—\$249,191
- Training interns in Accounting and Computer operations—\$61,000
- Health care projects with the United States Department of Health and Human Services—\$21,000
- Training for the Public Auditors to sharpen their skills for auditing of Compact and local funds—\$111,400
- GIS systems for support of economic development and land ownership issues—\$149,025

- Continuation of installation of a new financial management computer system— \$153,000

Maintenance Assistance Program

The FSM and the RMI remain eligible for the OIA Maintenance Assistance Program. The program was designed to stimulate and support the development of maintenance institutions in the island governments. The program does not focus on repairs. It instead focuses on changing those conditions that allow poor maintenance practices to exist. The funding underwrites training, education, and technical advice related to maintenance. Funding can be used to purchase specialized equipment or information systems related to maintenance. The program also funds the cost of inventories of maintenance needs and the development of maintenance plans. The program offers an ongoing assessment of its effectiveness through annual site visits by teams of engineers.

During FY 2004, the following Maintenance Assistance Program grants were awarded the FAS. In most cases, the agency receiving the grant provided an equal matching amount.

A. FSM

- College of Micronesia trades apprenticeship program—\$100,000
- Pohnpei Utilities Corporation training of Chuuk Utilities personnel—\$2,900
- Kosrae State government road maintenance equipment—\$240,000
- Pohnpei State government facilities management training—\$11,000
- Yap State vocational training—\$100,000
- PUC operations review and rate tariff study—\$50,000
- Kosrae Utilities Authority strategic plan development—\$5,000
- KUA power plant maintenance designs and specifications—\$18,500
- KUA purchase and installation prepayment electric meters—\$58,250
- KUA staff training—\$15,250

B. RMI

- Kwajalein Atoll Joint Utility Resource apprenticeship program—\$56,300
- KAJUR management training—\$58,000
- RMI Public Works heavy equipment operations and maintenance training—\$42,000
- Ministry of Resources and Development installation of and database systems for the outer island solar systems project—\$59,000
- R&D solid waste reduction and recycling improvements—\$109,000
- Economic Policy, Planning and Statistics Office maintenance prioritization system—\$37,000
- Ministry of Health Majuro Hospital redevelopment plan—\$47,000

Coral Reef Initiative

Healthy coral reef resources are the cornerstone of the economy and environment of island communities, from the United States Virgin Islands to Guam. Coral reefs provide storm protection, habitat to marine fish species, and support important tourism and recreational industries. These resources are now threatened by a variety of stresses including poor water quality, over-harvesting, disease, and bleaching (loss of symbiotic algae). OIA has been the principal agency providing technical and financial assistance to Micronesia for coral reef management and protection, with additional technical and grant support for monitoring and management provided by the National Oceanic and Atmospheric Administration's Coral Reef Conservation Program. OIA has also been instrumental in promoting their involvement in the United States Coral Reef Task Force.

A major initiative has been support for the development and implementation of a Blueprint for Conserving the Biodiversity of the Federated States of Micronesia. This effort will ultimately lead to a national network of protected areas. Support for coral reef assessments in the Marshall Islands is creating a national database on marine resources for managers and increasing awareness among local communities of the value of their natural resources. OIA has also promoted regional cooperation through support for the Marine Resources Pacific Consortium (MAREPAC). MAREPAC has helped to build bridges among the regional community-based environmental organizations, regional marine resource management agencies, institutions of higher education (the College of the Marshall Islands, the College of Micronesia-FSM, Northern Marianas College, Palau Community College and the University of Guam) and research facilities.

Other United States Domestic Federal Programs

The FSM and RMI retain eligibility under the amended Compact for a wide variety of Federal programs offered by several Federal departments. As noted earlier, a major change in the Compact is the awarding of Supplemental Education Grants in lieu of support from certain programs that had been previously funded by the Departments of Education, Health and Human Services and Labor. FY 2004 was the last year of eligibility for certain Federal programs from these departments. SEG funds will be awarded beginning in FY 2005.

United States Department of Agriculture

FSM

The United States Department of Agriculture provides grants, technical assistance, and loans to the FSM. Grants are for Land Grant programs of the College of Micronesia and for forestry and soil conservation services. Low interest, long-term loans mainly for housing improvement and business development, are provided through the Rural Housing Service which maintains an office in each state of the FSM. The FSM

Telecommunications Corporation's modern infrastructure was funded by a Rural Utilities Service low-interest, long-term loan.

Benefits that have accrued to the FSM through the USDA programs include:

- state of the art telecommunication system, which is still improving and expanding throughout the FSM,
- improved housing and community facilities,
- initiatives to reduce soil erosion through reforestation and conservation programs, and
- improved farming, nutrition and youth services in rural areas.

RMI

The United States Department of Agriculture currently provides grants, technical assistance, loans, and food commodities to the RMI. Annual grants are provided for administration and distribution of food commodities to residents of the four atolls affected by nuclear testing and Land Grant funds to the College of the Marshall Islands. Technical assistance has been provided through the Tropical Aquaculture Center in Honolulu for two projects, one for giant clam production and one project is pearl oyster production. Grants as well as low interest, long-term loans mainly for housing improvement and business development are provided through the Rural Housing Service. Long-term loans were provided to the Marshall Islands National Telecommunications Authority, and Marshalls Energy Company, through the Rural Utilities Service.

Benefits that have accrued to the RMI through the USDA programs include:

- State of the art telecommunication system, which is still improving and expanding throughout the Republic,
- More electrical power generation capability in Majuro and Jaluit, improved housing for families, advancement of postsecondary education,
- Initiation of projects with economic potential in aquaculture, and
- Improvement in nutrition for the four atoll residents receiving USDA food commodities.

United States Department of Commerce

FSM

The United States Department of Commerce provided grants in the Federated States of Micronesia for economic development projects and provides annual funding for operation of the Pacific Business Center. Grants are available for water system expansion and marine resource development.

The Economic Development Administration of the United States Department of Commerce provides funding for the operation of the Pacific Business Center at the University of Hawaii. The purpose of the Pacific Business Center is to foster economic development and expand employment opportunities in the Pacific area, including all of the FAS.

The United States Department of Commerce, National Oceanic and Atmospheric Administration, National Weather Service provides monitoring, equipment upgrades and technical assistance for three weather stations in the FSM.

The United States Department of Commerce, National Oceanic and Atmospheric Administration, Coral Reef Conservation Program has provided funding to support work promoting wise management and sustainable use of coral reef resources in the FSM through its Coral Reef Conservation Grants.

RMI

The United States Department of Commerce provided grants in the Republic of the Marshall Islands for economic development projects. Most significant have been grants for development of pearl oyster culture, and giant clam (*Tridacnidae*) farming which show promise as potential profitable ventures. Such funding has contributed and will continue to contribute to economic development in the Republic.

The Economic Development Administration of the United States Department of Commerce provides funding for the operation of the Pacific Business Center at the University of Hawaii. The purpose of the Pacific Business Center is to foster economic development and expand employment opportunities in the Pacific area, including the RMI.

The United States Department of Commerce, National Oceanic and Atmospheric Administration, National Weather Service provides monitoring, equipment upgrade, including maintenance and repair, and technical assistance for a weather service station in the Republic of the Marshall Islands.

The United States Department of Commerce, National Oceanic and Atmospheric Administration, Coral Reef Conservation Program has provided funding to support work promoting wise management and sustainable use of coral reef resources in the RMI through its Coral Reef Conservation Grants.

United States Department of Labor

The United States Department of Labor administers Workforce Investment Act (WIA) programs in both countries through FY 2004. As noted above, the program is being folded into the SEG.

United States Department of Education

Funds provided under most Department of Education programs have been folded into the SEG beginning with FY 2005. The exceptions are programs that provide payments to aid individuals, including Pell grants awarded for students attending postsecondary education institutions and grants to support individuals with disabilities. In addition, students who were in the colleges in the FSM and RMI at the time the amended Compact was enacted, continue to remain eligible for work-study programs and supplemental education grants for up to four academic years, to enable them to complete their course of study.

United States Department of Health and Human Services

Under the amended Compact, grants and technical assistance from the Department of Health and Human Services continue to be extended to the FSM and RMI for a variety of programs, including public health emergency preparedness, maternal, adolescent, and child health, family planning, sexually transmitted diseases, tuberculosis, AIDS and HIV prevention, community mental health, substance abuse, diabetes, and preventive health services. The Department has installed a senior Public Health Service physician in the OIA Honolulu Office to provide oversight over these programs in the FAS and throughout the Pacific region, and also to coordinate with the Department of the Interior and embassies in Majuro and Kolonia.

Funding for the largest of HHS programs, Head Start, has been folded into the SEG beginning in FY 2005.

(C) The Status of Economic Policy Reforms:

The RMI and FSM are now in the early stages of developing reforms in economic policy. Discussions are under way among these governments, the United States Government and international agencies such as the Asian Development Bank and the World Bank to make effective use of technical assistance funds and amended Compact capacity building grants to increase local capability.

(D) The Status of Efforts to Increase Investment:

On September 23–24, 2004, the Secretary of the Interior hosted a Conference on Business Opportunities in the Islands. This event is the successor to the 2003 Investment Development Conference for the Territories and included, for the first time, representatives of the RMI, the FSM and Palau. Potential projects in a wide range of industry sectors from tourism to fishing and critical infrastructure were discussed in a series of breakout sessions and panel meetings, and featured speakers from the island governments and business communities. The purpose of the conference was to introduce

the islands to a mainland business community, and give both sides an opportunity to network and forge partnerships, with the ultimate aim of stimulating private sector-led economic development. Follow up efforts have revealed some interest in projects in all jurisdictions, including the RMI and all four states of the FSM. These tracking efforts will continue into 2005. As a further follow up, a series of business opportunities missions, modeled on Department of Commerce foreign trade missions, are now in the planning stages and will be launched in 2005.

(E) Recommendations on Ways to Increase the Effectiveness of United States Assistance and to Meet Overall Economic Performance Objectives:

The amended Compacts contain many new accountability, reporting and review requirements designed to increase the effectiveness of United States assistance. We need to see how implementation of these mechanisms is succeeding before we will be in a position to make recommendations regarding further improvements. We will continue to analyze how implementation of the new safeguards is working and will report further in subsequent annual reports.